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TAGS: EFIN ECON PGOV CH
SUBJECT: CHINA FINANCIAL FUTURES EXCHANGE WAITING FOR STATE COUNCIL APPROVAL

REF: 07 SHANGHAI 251

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¶1. (SBU) Summary: In a March 5 meeting with Consulate TDY Econ Officer, China Financial Futures Exchange (CFFEX) Research and Development Head Dr. Zhang Xiaogang and his staff provided a status update on CFFEX preparations to launch a stock index future. Licenses have been granted for 75 futures brokers and mock trading has been carried out for almost one and a half years. CFFEX is awaiting State Council approval to launch the stock index future, after which time it will take one to two months to finalize regulations and commence trading. Risk averse policy makers fear that stock index future trading could precipitate a stock market crash.

Building Membership, Still Waiting for a Green Light

¶2. (SBU) Though CFFEX was inaugurated on September 8, 2006 (reftel), the exchange has yet to begin trading its first product, a stock index future based on the CSI 300. (Note: the CSI (China Securities Index) 300 represents 300 companies listed on China's Shanghai and Shenzhen Stock Exchanges, known as the Hushen 300 in Chinese. Firms are included in the index based on a formula that includes total market capitalization and share tradability. End note.) CFFEX has been overseeing mock trading exercises since October of 2006, which include the participation of CFFEX's trading members.

¶3. (SBU) The membership of CFFEX has expanded to a total of 75 across all the membership classes. According to Dr. Zhang and as available on CFFEX's website (), there are
12 Comprehensive Clearing Members (quanmian jiesuan huiyuan); 39 Clearing Members (jiaoyi jiesuan huiyuan); and 24 Trading Members (jiaoyi huiyuan). All of these CFFEX members are established as Futures Brokers and all are fully licensed.

These brokers will trade for their clients, such as securities firms or regulator-approved insurance companies. In the future commercial banks may be allowed as Special Clearing Members (teshu jiesuan huiyuan, of which there are none at the present time) and institutional investors, including securities firms, fund managers and QFIIs will be allowed as members, but specific regulations have not been drawn up yet for these classes of members.

¶4. (SBU) After building a substantial membership and carrying out many months of mock trading, CFFEX is waiting for a green light from the State Council to commence actual trading of the CSI 300 Index Futures. Dr. Zhang noted that the launch is a political issue because by creating a means to hold short positions, some leaders are nervous that stock market volatility could increase dramatically and possibly lead to social disturbances. Similarly, interlocutors at Chinese securities firms guessed that the index futures would not be launched until the new financial sector leadership was in place and that it was unlikely that a single individual would advocate the launch because of the possible negative market repercussions. Therefore, the go-ahead would come through a process of consensus building. One securities firm manager in Shanghai thought it was unlikely that stock futures would be launched before the Beijing Olympics. Once the futures are officially approved for launch, Dr. Zhang estimated it would take one to two months to finalize specific trading regulations and actually commence trading.

Managing Risk

¶5. (SBU) CFFEX is aiming to limit the use of its instruments to hedging activities, rather than as tools for speculation. As

such, the exchange has initiated an investor education campaign for its members and has established a regulatory framework to pursue this goal. CFFEX will take a "step-by-step" approach to its members that will entail a higher required margin on trades until a member's reputation is established. Net short and long positions will be allowed, but outstanding positions will be limited to 600 contracts, which are RMB 1 million each. The large contract size itself is designed to deter speculators as well. Institutional investors will be allowed to apply for higher limits on the level of contracts outstanding. All trades will be subject to a pre-execution credit check, and margins will be collected on both sides of the trade, even if a firm holds both long and short positions.

¶6. (SBU) Oversight for financial futures trading will encompass the spectrum of regulatory agencies. The Futures Supervision Department of the China Securities Regulatory Commission (CSRC) will oversee trading activities. The CSRC established a third-party institution in 2006 to facilitate futures trades, the China Futures Margin Monitoring Center. Each trading institution will be overseen by their respective regulators, for example, the China Banking Regulatory Commission (CBRC) will oversee commercial banks' trading activities.

History Lends to a Cautious Approach

¶7. (SBU) When asked about China's previous experience introducing financial futures in the 1990s, which resulted in a bond market crash, Dr. Zhang and his staff drew contrasts with the present context for futures trading and the 1990s. To begin with, in the previous decade the legal framework for futures trading was very weak, with no regulations to support trading activity. The authorities have established and strengthened regulations, beginning with Futures Trading Regulations passed by the State Council in 1997. The 1990s bond market crash is one reason that the current framework for futures trading leans more towards risk mitigation than efficiency. Dr. Zhang's staff

noted that the smooth and constructive performance of the commodities futures market has helped to lessen concern. But risk averse authorities with an incomplete understanding of complicated financial derivatives err on the side of caution.

Investors Eager for Stock Hedging Instruments

¶8. (SBU) Dr. Zhang and his staff noted strong interest among institutional investors for stock hedging tools. This sentiment was echoed by a director at a foreign-invested securities firm, who said that the firm's clients were very interested in the proposed index future. Currently investors can try to create proxy hedges with instruments in the Hong Kong and Singapore markets, but these offer imperfect coverage and limited liquidity. Dr. Zhang thought that liquidity in China would be ample, given a demand for both long and short positions.

¶9. (SBU) Dr. Zhang previewed traded financial derivatives that might follow the stock index future. His team is currently researching exchange-traded stock index options and treasury bond futures. They have done extensive research on these types of instruments in U.S. markets.
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